

**Statement of  
Financial Accounting Standards  
No. 34**

**Revised 22 September 2005**

Translated by

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**Statement of Financial Accounting Standards No.34**

**Financial Instruments: Recognition and Measurement**

**I Introduction**

- (1) This Statement establishes the accounting standards for financial instruments (including derivatives). Requirements for disclosing information about financial instruments are in this statement and the Statement of Financial Accounting Standards No. 36, *Financial Instruments: Disclosure and Presentation*.
- (2) This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.
- (3) There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:
  - (a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;
  - (b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments

(for example, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

- (c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and
- (d) when the non-financial item that is the subject of the contract is readily convertible to cash.

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 2 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, whether they are within the scope of this Standard.

A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with (a) or (d) described above is within the scope of this Standard. Such a contract cannot be entered into for the entity's expected purchase, sale or usage requirements.

- (4) This Standard shall be applied to all types of financial instruments, except:
  - (a) Long-term Investments under Equity Method (follow the principles set out in the Statement of Financial Accounting Standards No. 5, *Long-term Investments under Equity Method*, No. 7, *Consolidated Financial Statements*, and No.31, *Interests in Joint Ventures*). However, entities shall apply this Standard to those investments that is accounted for under this Standard

according to those Standards described above. Entities shall also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in the Statement of Financial Accounting Standards No. 36, *Financial Instruments: Disclosure and Presentation*.

- (b) Rights and obligations arising under leases (follow the principles set out in the Statement of Financial Accounting Standards No. 2, *Leases*). However, derivatives that are embedded in leases shall apply this Standard.
- (c) Employers' rights and obligations under employee pension plans (follow the principles set out in the Statement of Financial Accounting Standards No. 18, *Accounting for Pensions*).
- (d) Rights and obligations arising under insurance contracts. Contracts that require a payment only if a particular level of the underlying climatic, geological, or other physical variables adversely affects the contract holder are also insurance contracts. However, derivatives that are embedded in insurance contracts shall apply this Standard. The issuer of financial guarantee contracts defined in paragraph 5(r) may elect to apply this Standard to such financial guarantee contracts.
- (e) Equity instruments issued by the entity (including options and warrants classified as equity). However, the holder of such equity instruments shall apply this Standard to those instruments.
- (f) Contracts for contingent consideration in a business combination (follow the principles set out in the Statement of Financial Accounting Standards No. 25, *Business Combinations*). This exemption applies only to the acquirer.
- (g) Contracts between an acquirer and a vendor in a business

combination to buy or sell an acquiree at a future date.

- (h) Financial instruments, contracts and obligations under share-based payment transactions, including transactions in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options) or in which the entity acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price (or value) of the equity instruments of the entity, except for contracts within the scope of paragraphs 2–3 of this Standard. A share option is a contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.
- (i) Loans and receivables originated by the entity.
- (j) Loan commitments. However, the following loan commitments are within the scope of this Standard:
  - (i) Loan commitments that the entity designates as financial liabilities at fair value through profit or loss. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall designate all its loan commitments in the same class as financial liabilities at fair value through profit or loss.
  - (ii) Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives.
  - (iii) Commitments to provide a loan at a below-market interest rate. Paragraph 98(d) specifies the subsequent measurement of liabilities arising from these loan commitments.

An issuer of loan commitments shall apply the Statements of

Financial Accounting Standards No. 9, *Contingencies and Subsequent Events*, to other loan commitments that are not within the scope of this Standard.

## II Definitions

- (5) The following terms used in this Standard are defined in the Statement of Financial Accounting Standards No. 36, *Financial Instruments: Disclosure and Presentation: financial instrument, financial asset, financial liability, equity instrument, and fair value*. The definitions of other terms used in this Standard are as follows:
  - (a) *Derivative*: a financial instrument or other contract within the scope of this Standard in accordance with paragraphs 2–3 with all three of the following characteristics:
    - (i) its value changes in response to the change in a specified interest rate, foreign exchange rate, financial instrument price, commodity price, credit rating, credit index, price index, or other variable (sometimes called the 'underlying');
    - (ii) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
    - (iii) it is settled at a future date.
  - (b) *Active market*: a market with all of the following conditions: (i) the products traded in the market are homogeneous, (ii) willing parties are available anytime in the market, and (iii)

price information is available for the public.

- (c) *Loans and receivables*: non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than:
- (i) those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading;
  - (ii) those that the entity upon initial recognition designates as at fair value through profit or loss;
  - (iii) those that the entity upon initial recognition designates as available-for-sale; or
  - (iv) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which cannot be classified as loans and receivables or held-to-maturity investments.

Loans and receivables include those originated by the entity and those not originated by the entity. Loans and receivables originated by the entity are created by the entity by providing money, goods, or services directly to a debtor, and loans and receivables not originated by the entity are loans and receivables other than those originated by the entity.

An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.

- (d) *Financial assets or financial liabilities at fair value through profit or loss*: financial assets or financial liabilities that meet either of the following conditions.
- (i) It is classified as held for trading. A financial asset or

financial liability is classified as held for trading if it is:

- 1 acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
  - 2 part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
  - 3 a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).
- (ii) Upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 12.
- (e) *Held-to-maturity investments*: non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than those that meet the definition of loans and receivables, those that the entity designates as available for sale, those that the entity upon initial recognition designates as at fair value through profit or loss.
- (f) *Available-for-sale financial assets*: non-derivative financial assets that are designated as available-for-sale or are not classified as, (i) held-to-maturity investments, (ii) financial assets at fair value through profit or loss, or (iii) loans and receivables.
- (g) *Amortized cost of a financial asset or financial liability*: the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization of any difference between that initial amount and the maturity amount, and minus any reduction for impairment or uncollectibility.

- (h) *Interest method (or effective interest rate method)*: a method of calculating the amortized cost and interest income or interest expense of a financial asset or a financial liability (or group of financial assets or financial liabilities). The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options), but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties, premiums or discounts, and transaction costs. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

A shorter period is used when the variable (eg interest rates) to which the fee, discount or premium, and transaction costs relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortization period is the period to the next such repricing date.

- (i) *Transaction costs*: incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.
- (j) *Firm commitment*: a binding agreement for the exchange of a specified quantity of resources at a specified price on a

specified future date or dates.

- (k) *Forecast transaction*: an uncommitted but anticipated future transaction.
- (l) *Hedging instrument*: a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial instrument whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item. Hedging is designating one or more hedging instruments of which changes in the fair value or cash flows will offset all or part of changes in the fair value or cash flows of a designated hedged item.
- (m) *Hedged item*: an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in future fair value or future cash flows and (b) is designated as being hedged.
- (n) *Hedge effectiveness*: the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.
- (o) *Regular way purchase or sale*: a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.
- (p) *Monetary items*: units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. A contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item.

- (q) *Non-monetary items*: assets and liabilities which are lack of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency.
- (r) *Financial guarantee contract*: a contract that requires the guarantor (issuer) to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment.
- (s) *Net investment in foreign countries*: the equity of foreign operations owned by the domestic entity or long-term advances to a foreign operation by the domestic entity.

### III Explanation

#### Derivatives

- (6) Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of \$1,000 if six-month LIBOR increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.
- (7) One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that

would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.

#### Transaction costs

- (8) Transaction costs include transfer taxes and duties, levies by regulatory agencies and securities exchanges, fees and commissions paid to agents (including employees acting as selling agents), and other necessary expenditures. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

#### Financial liabilities held for trading

- (9) Financial liabilities held for trading include:
  - (a) derivative liabilities that are not accounted for as hedging instruments;
  - (b) obligations to deliver financial assets borrowed by a short seller;
  - (c) financial liabilities that are incurred with an intention to repurchase them in the near term (eg a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and
  - (d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

The fact that a liability is used to fund trading activities does not in itself make that liability a held for trading financial liability.

## Loans and receivables

- (10) Any non-derivative financial asset with fixed or determinable payments (including loan assets, trade receivables, and investments in debt instruments) could potentially meet the definition of loans and receivables. However, a financial asset that is quoted in an active market does not qualify for classification as a loan or receivable. Financial assets that do not meet the definition of loans and receivables may be classified as held-to-maturity investments if they meet the conditions for that classification (see paragraphs 5(e)). On initial recognition of a financial asset that would otherwise be classified as a loan or receivable, an entity may designate it as a financial asset at fair value through profit or loss, or available-for-sale.

## Financial assets and financial liabilities designated as at fair value through profit or loss

- (11) A financial asset or financial liability may be designated as at fair value through profit or loss only if its fair value is verifiable. For the purposes of this requirement, the fair value of a financial asset or financial liability is verifiable if, and only if, the variability in the range of reasonable fair value estimates made in accordance with this Standard is low. This requirement is met if, for example, the fair value estimate is based on:
- (a) observable current market transactions in the same instrument (ie without modification or repackaging);
  - (b) a valuation technique whose variables include primarily observable market data and that is calibrated periodically to observable current market transactions in the same instrument (ie without modification or repackaging) or to other observable current market data; or

- (c) a valuation technique that is commonly used by market participants to price the instrument and has been demonstrated to provide realistic estimates of prices obtained in actual market transactions.
- (12) A financial asset or financial liability may be designated as at fair value through profit or loss only when either of the following conditions is met:
- (a) the financial asset or financial liability designated is a hybrid contract. Hybrid contracts with the following conditions, however, shall not be designated as at fair value through profit or loss:
    - (i) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or
    - (ii) it is clear when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortized cost.
  - (b) doing so results in more relevant information so that it is permitted to designate a financial asset or financial liability as at fair value through profit or loss, because either:
    - (i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
    - (ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information

about the group is provided internally on that basis to the entity's key management personnel, for example the entity's board of directors and chief executive officer.

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured, and derivatives which are linked to and must be settled by delivery of such unquoted equity instruments shall not be designated as at fair value through profit or loss.

### Accounting mismatch

(13) The following examples show when an entity measures assets or liabilities or recognize the gains and losses on them on different bases which results in an accounting mismatch.

- (a) An entity has liabilities whose cash flows are contractually based on the performance of assets that would otherwise be classified as available for sale. For example, an insurer may have liabilities containing a discretionary participation feature that pay benefits based on realised and/or unrealised investment returns of a specified pool of the insurer's assets. If the measurement of those liabilities reflects current market prices, classifying the assets as at fair value through profit or loss means that changes in the fair value of the financial assets are recognized in profit or loss in the same period as related changes in the value of the liabilities.
- (b) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, if only some of the instruments would be measured at fair value through profit or loss (ie are derivatives, or are classified as held for trading) or the requirements for hedge accounting are not met, for example because the requirements for effectiveness are not met, changes in the fair value of those financial assets and financial liabilities cannot be recognized

in profit or loss in the same period.

- (c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. If the entity does not qualify for hedge accounting because none of the instruments is a derivative, there is a significant inconsistency in the recognition of gains and losses. For example:
  - (i) the entity has financed a portfolio of fixed rate assets with fixed rate debentures whose changes in fair value tend to offset each other. A measurement inconsistency arises when those assets are classified as available-for-sale and those liabilities are measured at amortized cost. Therefore, reporting both the assets and the debentures at fair value through profit or loss corrects the inconsistency.
  - (ii) the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. Both of them are measured at amortized cost and a gain or loss is recognized each time a bond is repurchased. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses.
- (14) To designate, at initial recognition, the financial assets and financial liabilities described in paragraph 13 as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time, if each transaction is designated as at fair value through profit or loss at its initial

recognition and, at that time, any remaining transactions are expected to occur.

- (15) It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. For example, assume an entity has a number of similar financial liabilities that sum to \$100,000 and a number of similar financial assets that sum to \$50,000 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (ie individual liabilities with a combined total of \$45,000) as at fair value through profit or loss.

Designation as at fair value through profit or loss can be applied only to the whole of a financial asset or financial liability. It could not designate either a component (eg changes in value attributable to a specific risk) or a proportion of a financial asset or financial liability.

#### **Performance evaluated on a fair value basis**

- (16) An entity may manage and evaluate the performance of a group of financial assets, financial liabilities or both on a fair value basis to obtain more relevant information. The focus in paragraph 12(b)(ii) is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments.
- (17) The following examples show when an entity evaluates performance of a group of financial assets, financial liabilities or both on a fair value basis.
- (a) The entity is a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest or dividends and changes in fair value. However, the entity shall apply to its controlled entities the

Statement of Financial Accounting Standards No. 5, *Long-term Investments under Equity Method*, and No. 7, *Consolidated Financial Statements*.

- (b) The entity has financial assets and financial liabilities that share one or more risks (eg interest rate risk) and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued structured products containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. A similar example could be an entity that originates fixed interest rate loans and manages the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.
- (c) The insurance company holds a portfolio of financial assets, manages that portfolio so as to maximise its total return, and evaluates its performance on that basis. The portfolio may be held to back specific liabilities, equity or both. If the portfolio is held to back specific liabilities, the condition in paragraph 12(b)(ii) may be met for the assets regardless of whether the liabilities are managed and evaluated on a fair value basis. The condition in paragraph 12(b)(ii) may be met when the insurer's objective is to maximise total return on the assets over the longer term even if amounts paid to holders of participating contracts depend on other factors such as the amount of gains realised in a shorter period or are subject to the insurer's discretion.
- (18) As noted in paragraph 17, the focus in paragraph 12(b)(ii) is on the way the entity manages and evaluates performance of the group of financial instruments. Accordingly, an entity that designates financial instruments as at fair value through profit or loss in accordance with paragraph 12(b)(ii) shall so designate all eligible financial instruments that are managed and evaluated together.

- (19) Documentation of the entity's strategy should be sufficient to demonstrate compliance with paragraph 12(b)(ii). Such documentation may be on a portfolio basis. For example, if the performance management system for a department—as approved by the entity's key management personnel—clearly demonstrates that its performance is evaluated on a total return basis, it is sufficient to demonstrate compliance with paragraph 12(b)(ii).

### Embedded derivatives

- (20) An embedded derivative is a component of a hybrid instrument. Some of the cash flows of a hybrid instrument vary in a way similar to a stand-alone derivative, since the hybrid instrument includes both one non-derivative host contract and one or more embedded derivatives. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, foreign exchange rate, financial instrument price, commodity price, credit rating, credit index, index of prices or rates, or other variable. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.
- (21) An embedded derivative shall be separated from the host contract if, and only if:
- the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
  - a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
  - the hybrid instrument is not measured at fair value through profit or loss (ie a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

If an embedded derivative is separated, the host contract shall be accounted for under this Standard if it is a financial instrument, and under other appropriate Standards if it is not a financial instrument.

- (22) The economic characteristics and risks of an embedded derivative are not closely related to the host contract in the following examples.
- A put option embedded in a debt instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in equity or commodity price or index is not closely related to a host debt instrument.
  - A call option embedded in an equity instrument that enables the issuer to reacquire that host equity instrument at a specified price is not closely related to the host equity instrument from the perspective of the holder (from the issuer's perspective, the call option is an equity instrument provided and excluded from the scope of this Standard).
  - An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension.
  - Equity-indexed interest or principal payments embedded in a debt instrument or insurance contract—by which the amount of interest or principal is indexed to the value of equity instruments—are not closely related to the host instrument (debt instrument or insurance contract) because the risks inherent in the host and the embedded derivative are dissimilar.
  - Commodity-indexed interest or principal payments embedded in a debt instrument or insurance contract—by which the amount of interest or principal is indexed to the

price of a commodity (such as gold)—are not closely related to the host instrument (debt instrument or insurance contract) because the risks inherent in the host and the embedded derivative are dissimilar.

- (f) An equity conversion feature embedded in a debt instrument is not closely related to the host debt instrument from the perspective of the holder of the instrument (from the issuer's perspective, the equity conversion option is an equity instrument and excluded from the scope of this Standard).
  - (g) A call, put, or prepayment option embedded in a debt instrument is not closely related to the host debt instrument unless the option's exercise price is approximately equal on each exercise date to the amortized cost of the debt instrument. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element.
  - (h) Credit derivatives that are embedded in a debt instrument and allow one party (the 'beneficiary') to transfer the credit risk of a particular reference asset, which it may not own, to another party (the 'guarantor') are not closely related to the host debt instrument, because the issuer (the 'guarantor') is exposed to the credit risk associated with the reference asset without directly owning it.
- (23) The economic characteristics and risks of an embedded derivative are closely related to the host contract in the following examples.
- (a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt instrument is closely related to the host, unless the hybrid instrument can be settled in such a way that the holder would not recover substantially all of its

recognized investment or the embedded derivative could at least double the holder's initial rate of return on the host instrument and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host instrument.

- (b) An embedded floor or cap on the interest rate on a debt instrument is closely related to the host debt instrument, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the instrument is issued, and the cap or floor is not leveraged in relation to the host debt instrument.
- (c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a debt instrument (eg a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host debt instrument because foreign currency gains and losses on monetary items are required to be recognized in profit or loss.
- (d) An embedded foreign currency derivative in a host non-financial contract (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract, provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies: (i) the functional currency of any substantial party to that contract; (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place.
- (e) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is:

- (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment),
  - (ii) contingent rentals based on related sales, or
  - (iii) contingent rentals based on variable interest rates.
- (f) An embedded prepayment option in an interest-only or principal-only strip is closely related to the host instrument, provided the host instrument:
- (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and
  - (ii) does not contain any terms not present in the original debt instrument.

### Separation of embedded derivatives

- (24) An embedded option-based derivative (such as an embedded put, call, cap and floor, or swaption) is separated from its host contract and its fair value is determined on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount from obtaining or issuing the hybrid instrument after separating the embedded derivative.

An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition.

- (25) Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However,

embedded derivatives that are classified as equity are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

- (26) If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid instrument and the fair value of the host contract. If the entity is unable to determine the fair value of the embedded derivative using this method, paragraph 86 applies and the hybrid instrument is designated as at fair value through profit or loss.

## Recognition

### Initial recognition

- (27) An entity shall recognize a financial asset or a financial liability in its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the financial instrument contract (including derivatives). The following are examples:
- (a) unconditional receivables and payables are recognized as assets or liabilities when the entity becomes a party to the contract (ie financial instrument) and, as a consequence, has a legal right to receive or a legal obligation to pay cash.
  - (b) assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognized until at least one of the parties has performed under the agreement and resulted that the other of the parties has a right to receive or an obligation to pay assets. For example, an entity that receives a firm order does not

generally recognize an asset (and the entity that places the order does not recognize a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been delivered or rendered.

- (c) a forward contract that is within the scope of this Standard is recognized as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero.
- (d) option contracts that are within the scope of this Standard are recognized as assets or liabilities when the holder or writer becomes a party to the contract.
- (e) planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

#### **Regular way purchase or sale of financial assets**

- (28) A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is recognized by using trade date accounting or settlement date accounting, rather than recognized as a derivative financial instrument. A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.
- (29) The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to:
  - (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and

- (b) the derecognition of an asset that is sold, the recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date.

Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date (when title passes).

- (30) The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to:
  - (a) the recognition of an asset on the day it is received by the entity, and
  - (b) the derecognition of an asset and the recognition of any gain or loss on disposal on the day that it is delivered by the entity.

When settlement date accounting is applied, an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date according to paragraph 110, ie the change in value is not recognized for assets carried at cost or amortized cost; it is recognized in profit or loss for assets classified as financial assets at fair value through profit or loss; and it is recognized in equity for assets classified as available-for-sale.

## **Measurement**

### **Initial measurement of financial assets and financial liabilities**

- (31) The fair value of a financial instrument on initial recognition is normally the transaction price (ie the fair value of the consideration given or received). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique. For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing

market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is a reduction of income or an expense unless it qualifies for recognition as some other type of asset.

### **Subsequent measurement of financial assets**

- (32) If a financial instrument that was previously recognized as a financial asset is measured at fair value and its fair value falls below zero, it shall be measured as a financial liability.
- (33) For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. Those changes of cash flows are recognized over the expected life of the financial asset or financial liability or before the next repricing date. A floating rate financial asset or floating rate financial liability is recognized initially at an amount equal to the principal receivable or payable on maturity, and re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

### **Held-to-maturity investments**

- (34) A debt instrument with a variable interest rate can satisfy the criteria for a held-to-maturity investment. Equity instruments cannot be held-to-maturity investments either because they have no maturity date (such as ordinary shares) or because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options and warrants). With respect to the definition of held-to-maturity investments, fixed or determinable payments and fixed maturity mean that a contractual arrangement defines the amounts and dates of payments to the holder, such as interest and principal payments. A significant risk of non-payment does not preclude classification of a financial asset as held-to-maturity as long as its contractual payments are fixed or determinable and the other criteria for that classification are met. If the terms of a perpetual debt

instrument provide for interest payments for an indefinite period, the instrument cannot be classified as held-to-maturity because there is no maturity date.

- (35) The criteria for classification as a held-to-maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially its entire carrying amount. The call option of the issuer, if exercised, simply accelerates the asset's maturity. However, if the financial asset is callable on a basis that would result in the holder not recovering substantially its entire carrying amount, the financial asset cannot be classified as a held-to-maturity investment. The entity considers any premium paid and capitalised transaction costs in determining whether the carrying amount would be substantially recovered.
- (36) A financial asset that is puttable (ie the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a held-to-maturity investment because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.
- (37) For most financial assets, fair value is a more appropriate measure than amortized cost, except for the held-to-maturity classification which an entity has a positive intention and the ability to hold to maturity. When an entity would like to classify a financial asset as a held-to-maturity investment, it shall take into account the practice of the entity in the current year and two preceding financial years.
- (38) A scenario that is only remotely possible is not something that is assessed by an entity in deciding whether it has the positive intention and ability to hold an investment to maturity.
- (39) Sales before maturity could satisfy the condition in paragraph 96(c)—and therefore not raise a question about the entity's intention to hold other investments to maturity—if they are attributable to any of the following:

- (a) a significant deterioration in the issuer's creditworthiness. For example, a sale following a downgrade in a credit rating by an external rating agency would not necessarily raise a question about the entity's intention to hold other investments to maturity if the downgrade provides evidence of a significant deterioration in the issuer's creditworthiness judged by reference to the credit rating at initial recognition. Similarly, if an entity uses internal ratings for assessing exposures which give a consistent, reliable and objective measure of the credit quality of the issuers, changes in those internal ratings may help to identify issuers for which there has been a significant deterioration in creditworthiness. If there is evidence that a financial asset is impaired (see paragraphs 52), the deterioration in creditworthiness is often regarded as significant.
- (b) a change in tax law that eliminates or significantly reduces the tax-exempt status of interest on the held-to-maturity investment (but not a change in tax law that revises the marginal tax rates applicable to interest income).
- (c) a major business combination or major disposition (such as a sale of a segment) that necessitates the sale or transfer of held-to-maturity investments to maintain the entity's existing interest rate risk position or credit risk policy (although the business combination is an event within the entity's control, the changes to its investment portfolio to maintain an interest rate risk position or credit risk policy may be consequential rather than anticipated).
- (d) a change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of particular types of investments, thereby causing an entity to dispose of held-to-maturity investments.
- (e) a significant increase in the industry's regulatory capital requirements that causes the entity to downsize by selling held-to-maturity investments.

- (f) a significant increase in the risk weights of held-to-maturity investments used for regulatory risk-based capital purposes, thereby causing an entity to dispose of held-to-maturity investments.
- (40) Circumstances other than those described in paragraphs 34–39 and 95–97 can indicate that an entity does not have a positive intention or the ability to hold an investment to maturity.
- (41) An entity assesses its intention and ability to hold its held-to-maturity investments to maturity not only when those financial assets are initially recognized, but also at each subsequent balance sheet date.

#### **Subsequent measurement of financial liabilities**

- (42) After initial recognition, an entity shall measure all financial liabilities at amortized cost, except for:
  - (a) Financial liabilities at fair value through profit or loss shall be measured at fair value.
  - (b) Derivative liabilities shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost.
  - (c) Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition in accordance with the Statement of Financial Accounting Standards No. 33, *Accounting for Transfers of Financial Assets and Extinguishments of Liabilities* shall be recognized for the consideration received. In subsequent periods, the entity shall recognize any income on the transferred asset and any expense incurred on the financial liability.
  - (d) Financial guarantee contracts as defined in paragraph 5

(unless those apply (a), (b) or (c)) and commitments to provide a loan at a below-market interest rate (unless those apply (a) or (b)) shall, after initial recognition, be measured by the issuer at the higher of:

- (i) the contingent liability determined in accordance with the Statement of Financial Accounting Standards No. 9, *Contingencies and Subsequent Events*; and
- (ii) the amount of deferred revenue initially recognized less, when appropriate, cumulative amortization in accordance with the Statement of Financial Accounting Standards No. 32, *Revenue*.

Financial liabilities that are designated as hedged items are subject to the hedge accounting requirements in paragraphs 118–133.

#### **Fair value measurement considerations**

- (43) Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in an involuntary transaction. However, fair value reflects the credit quality of the instrument.
- (44) The fair value of a financial liability with a demand feature (eg a demand deposit of a bank) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

#### **Active market: quoted price**

- (45) The existence of published price quotations in an active market is the best evidence of fair value. When current quoted prices are unavailable, the quoted price of the most recent transaction can be identified as fair value as long as there has not been a significant change in economic circumstances since the time of the transaction.

If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

#### **No active market: valuation technique**

- (46) If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. A valuation technique shall (a) incorporate all factors that market participants would consider in setting a price and (b) be consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.
- (47) Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.
- (48) In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for

financial instruments having substantially the same terms and characteristics, including the credit quality of the debtor, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

- (49) The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (ie similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis). Alternatively, provided there is no change in the credit risk of the debtor and applicable credit spreads after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate, adjusting for the change in the benchmark interest rate from the origination date. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate, for any differences from the instrument being valued.

#### **No active market: equity instruments**

- (50) The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument is reliably measurable if:
- (a) the variability in the range of reasonable fair value estimates is not significant for that instrument, or

- (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.
- (51) There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument is likely not to be significant. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

#### **Impairment and uncollectibility of financial assets**

- (52) A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Those objective evidences include:
- (a) significant financial difficulty of the issuer or obligor;
- (b) a breach of contract, such as a default or delinquency in interest or principal payments;
- (c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- (d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- (e) the disappearance of an active market for that financial asset because of the issuer's financial difficulties;

- (f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
- (i) adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or
  - (ii) changes in national or local economic conditions that correlate with defaults on the assets in the group (eg an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, or adverse changes in industry conditions that affect the borrowers in the group).
- (g) a significant adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, which indicates that the cost of the investment in the equity instrument may not be recovered.
- (h) a significant or prolonged decline in the fair value of an investment in an equity instrument.

A downgrade of an entity's credit rating is not, of itself, evidence of impairment, but it may be evidence of impairment when considered with other available information.

#### **Financial assets carried at amortized cost**

- (53) An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that

are not individually significant.

If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognized are not included in a collective assessment of impairment.

- (54) Impairment of a financial asset carried at amortized cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortized cost. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortized cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

#### **Hedging**

##### **Hedging instruments**

##### *Qualifying instruments*

- (55) A derivative may be designated as a hedging instrument provided the conditions in paragraph 120 are met, except for some written options (see paragraph 57). However, a non-derivative financial asset (eg foreign currency-denominated receivables originated by the entity) or non-derivative financial liability may be designated as a

hedging instrument only for a hedge of a foreign currency risk.

- (56) An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.
- (57) The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item. Therefore, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a call option embedded in a callable liability). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows. Accordingly, it can qualify as a hedging instrument.
- (58) A held-to-maturity investment carried at amortized cost may be designated as a hedging instrument in a hedge of foreign currency risk.
- (59) An investment in an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured or a derivative that is linked to and must be settled by delivery of such an unquoted equity instrument cannot be designated as a hedging instrument.
- (60) For hedge accounting purposes, only instruments that involve a party external to the reporting entity can be designated as hedging instruments. Although individual entities within a consolidated group or divisions within an entity may enter into hedging transactions with other entities within the group or divisions within the entity, any such intragroup transactions are eliminated in the consolidated financial statements of the group and the individual or separate financial statements of the parent. Therefore, such hedging transactions do not qualify for hedge accounting in the consolidated

financial statements of the group and the individual or separate financial statements of the parent. However, they may qualify for hedge accounting in segment reporting or the individual or separate financial statements of the subsidiaries.

*Designation of hedging instruments*

- (61) There is normally a single fair value measure for a hedging instrument in its entirety, and a hedging relationship is designated by an entity for a hedging instrument in its entirety because the factors that cause changes in fair value are co-dependent. The only exceptions permitted are: (a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value; and (b) separating the interest element and the spot price of a forward contract. These exceptions are permitted because the intrinsic value of the option and the premium on the forward can generally be measured separately.

A dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting.

- (62) A proportion of the entire hedging instrument, such as 50 per cent of the notional amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.
- (63) A single hedging instrument may be designated as a hedge of more than one type of risk provided that:
- the risks hedged can be identified clearly;
  - the effectiveness of the hedge can be demonstrated; and
  - it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.

- (64) Two or more derivatives, or proportions of them, may be viewed in combination and jointly designated as the hedging instrument, including when the risk(s) arising from some derivatives offset(s) those arising from others. In the case of a hedge of currency risk, two or more non-derivatives or proportions of them, or a combination of derivatives and non-derivatives or proportions of them, may be viewed in combination and jointly designated as the hedging instrument as well. However, an interest rate collar or other derivative instrument that combines a written option and a purchased option does not qualify as a hedging instrument if it is, in effect, a net written option (for which a net premium is received). Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument if none of them is a written option or a net written option.

### **Hedged items**

#### *Qualifying items*

- (65) A hedged item can be a recognized asset or liability, an unrecognized firm commitment, a highly probable forecast transaction, or a net investment in a foreign operation. The hedged item can be:
- (a) a single asset, liability, firm commitment, highly probable forecast transaction, or net investment in a foreign operation,
  - (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions, or net investments in foreign operations with similar risk characteristics, or
  - (c) a portfolio of financial assets or financial liabilities that share the interest rate risk being hedged, or a portion of such a portfolio.

A held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk because designation of an investment as held to maturity requires an intention to hold the

investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates. However, a held-to-maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.

- (66) For hedge accounting purposes, only assets or liabilities which need not to be eliminated in the consolidated financial statements, or firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that hedge accounting can be applied to transactions between entities or segments in the same group only in the individual or separate financial statements of the subsidiaries or segments and not in the consolidated financial statements of the group and the individual or separate financial statements of the parent. As an exception, the foreign currency risk of an intragroup monetary item (eg a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with the Statement of Financial Accounting Standards No. 14, *The Effects of Changes in Foreign Exchange Rates*.
- (67) In consolidated financial statements, the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. For this purpose an entity can be a parent, subsidiary, associate, joint venture or branch. When the foreign currency risk of a forecast intragroup transaction will affect consolidated profit or loss, the intragroup transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same group if there is an onward sale of the inventory to a party external to the group. Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use the plant and equipment in its operations may affect consolidated profit or loss.

This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognized for the plant and equipment may change if the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity. On the contrary, if the foreign currency risk of a forecast intragroup transaction does not affect consolidated profit or loss, the intragroup transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management charges between members of the same group which are unrelated to external transactions.

- (68) A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign currency risk, because the other risks being hedged are general business risks which cannot be specifically identified and measured.
- (69) An equity method investment cannot be a hedged item in a fair value hedge because the equity method recognizes in profit or loss the investor's share of the associate's profit or loss, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge because consolidation recognizes in profit or loss the subsidiary's profit or loss, rather than changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

*Designation of financial instruments as hedged items*

- (70) If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged item (such as a risk-free interest rate or

benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).

- (71) In a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (ie a portfolio hedge), the portion hedged may be designated in terms of an amount of a currency (eg an amount of NT dollars, US dollars and euros) rather than as individual assets or liabilities. Although the portfolio may, for risk management purposes, include assets and liabilities, the amount designated is an amount of assets or an amount of liabilities. Designation of a net amount including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable items, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate on the basis of expected, rather than contractual, repricing dates. When the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

*Designation of non-financial items as hedged items*

- (72) Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for foreign currency risks.

*Designation of groups of items as hedged items*

- (73) Similar assets or similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk

for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. For example, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7 percent to 13 percent would be inconsistent with this provision.

- (74) Because an entity assesses hedge effectiveness by comparing the change in the fair value or cash flow of a hedging instrument (or group of similar hedging instruments) and a hedged item (or group of similar hedged items), comparing a hedging instrument with an overall net position (eg the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than with a specific hedged item, does not qualify for hedge accounting.

### **Hedge accounting**

- (75) Hedge accounting recognizes the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item.
- (76) Hedging relationships are of three types:
- (a) fair value hedge: a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss. An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate bond as a result of changes in interest rates by the issuer or by the holder.
  - (b) cash flow hedge: a hedge of the exposure to variability in cash

flows that is attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debt) or with a highly probable forecast transaction and could affect profit or loss. An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (ie a hedge of a future transaction where the future cash flows being hedged are the future interest payments).

- (c) hedge of a net investment in a foreign operation: a hedge of the exposure to foreign currency risk associated with a net investment in a foreign operation.
- (77) A hedge of a firm commitment (eg a hedge of the change in fuel price relating to an unrecognized contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. A hedge of the foreign currency risk of a firm commitment, however, may be accounted for as a fair value hedge or as a cash flow hedge. For example, it may be accounted for as a fair value hedge or as a cash flow hedge a hedge of the foreign currency risk of an unrecognized firm commitment to buy airplanes in a fixed amount in foreign currency with hedging instruments by an airline entity. If a hedge of the foreign currency risk of a firm commitment is accounted for as a cash flow hedge, it is accounted for as a hedge of a forecast transaction.

### **Assessing hedge effectiveness**

- (78) A hedge is regarded as highly effective only if both of the following conditions are met:
- (a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated in various ways, including by comparing past changes in the fair value or cash flows of the hedged item that are attributable to the hedged

risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument.

- (b) The actual results of the hedge are within a range of 80–125 percent. For example, if actual results are such that the loss on the hedging instrument is \$120 and the gain on the hedged item is \$100, offset can be measured by  $120/100$ , which is 120 percent, or by  $100/120$ , which is 83 percent. In this example, assuming the hedge meets the condition in (a), the entity would conclude that the hedge has been highly effective.
- (79) The method an entity adopts for assessing hedge effectiveness depends on its risk management strategy. In some cases, an entity adopts different methods to assess for different types of hedges. If the principal terms of the hedging instrument and of the hedged asset, liability, firm commitment or highly probable forecast transaction are the same, the changes in fair value and cash flows attributable to the risk being hedged may be likely to offset each other fully, both when the hedge is entered into and afterwards. For example, an interest rate swap is likely to be an effective hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item.
- (80) Sometimes the hedging instrument offsets only part of the hedged risk. For example, a hedge would not be fully effective if the hedging instrument and hedged item are denominated in different currencies that do not move in tandem. Also, a hedge of interest rate risk using a derivative would not be fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk.
- (81) To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk, and not merely to the entity's general business risks, and must ultimately affect the entity's profit or loss.

A hedge of the risk of obsolescence of a physical asset or the risk of expropriation of property by a government is not eligible for hedge accounting; effectiveness cannot be measured because those risks are not measurable reliably.

- (82) In the case of a hedge of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule for financial assets and financial liabilities that shows the net interest rate exposure for each time period, provided that the net exposure is associated with a specific asset or liability giving rise to the net exposure, and hedge effectiveness is assessed against that asset or liability.
- (83) This Standard does not specify a single method for assessing hedge effectiveness. An entity's documentation of its hedging strategy includes its procedures for assessing effectiveness. Those procedures state whether the assessment includes all of the gain or loss on a hedging instrument or whether the instrument's time value is excluded. Effectiveness is assessed, at a minimum, at the time an entity prepares its annual or interim financial statements. If the principal terms of the hedging instrument and of the hedged asset, liability, or forecast transaction are the same, the changes in fair value and cash flows attributable to the risk being hedged may be likely to offset each other fully, both when the hedge is entered into and afterwards. In addition, a hedge of a highly probable forecast purchase of a commodity with a forward contract is likely to be highly effective if:
- (a) the forward contract is for the purchase of the same quantity of the same commodity at the same time and location as the hedged forecast purchase;
  - (b) the fair value of the forward contract at inception is zero; and
  - (c) either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and the change in expected cash flows on the highly probable forecast transaction is based on the spot price for the

commodity, or the change in the discount or premium on the forward contract is included in the assessment of effectiveness and the change in expected cash flows on the highly probable forecast transaction is based on the forward price for the commodity.

- (84) In assessing the effectiveness of a hedge, an entity generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.

## IV Accounting standards

### Embedded derivatives

- (85) An embedded derivative shall be separated from the host contract and accounted for as a derivative under this Standard if, and only if:
- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
  - (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
  - (c) the hybrid instrument is not measured at fair value through profit or loss (ie a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

If an embedded derivative is separated, the host contract shall be

accounted for under this Standard if it is a financial instrument, and under other appropriate Standards if it is not a financial instrument.

- (86) If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at the subsequent balance sheet dates, it shall designate the entire hybrid contract as at fair value through profit or loss.

### Recognition

#### Initial recognition

- (87) An entity shall recognize a financial asset or a financial liability in its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the financial instrument contract. Therefore, an entity shall recognize all contract rights or contract obligations of derivatives as assets or liabilities in its balance sheet.

#### Trade date accounting or settlement date accounting

- (88) A regular way purchase or sale of financial assets is recognized using either trade date accounting or settlement date accounting. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets.

### Derecognition

- (89) Derecognition of financial assets or financial liabilities shall follow the Statement of Financial Accounting Standards No. 33, *Accounting for Transfers of Financial Assets and Extinguishments of Liabilities*.

### Measurement

#### Initial measurement of financial assets and financial liabilities

- (90) When a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

#### Subsequent measurement of financial assets

- (91) For the purpose of measuring a financial asset after initial recognition, financial assets are, according to paragraph 5, classified into the following four categories:

- (a) Financial assets at fair value through profit or loss;
- (b) Held-to-maturity investments;
- (c) Loans and receivables; and
- (d) Available-for-sale financial assets.

These categories apply to measurement and profit or loss recognition under this Standard. The entity may use other descriptors for these categories or other categorisations when presenting information in the financial statements. If, for example, investments of bonds with no active market are classified as 'Loans and receivables', they can be presented as 'Investments of bonds with no active market' in the financial statements.

- (92) After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:

- (a) Loans and receivables shall be measured at amortized cost using the effective interest method. If, however, the result to use the straight-line method approximates the result to use the effective interest method, the straight-line method may be

used.

- (b) Held-to-maturity investments shall be measured at amortized cost using the effective interest method. If, however, the result to use the straight-line method approximates the result to use the effective interest method, the straight-line method may be used.
- (c) Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured shall be measured at cost.
- (d) Derivatives that are linked to and must be settled by delivery of equity instruments described in (c) shall be measured at cost.

Financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 118–133. All financial assets except those measured at fair value through profit or loss are subject to review for impairment in accordance with paragraphs 111–117.

- (93) If a financial instrument that was previously recognized as a financial asset is measured at fair value and its fair value falls below zero, it shall be measured as a financial liability in accordance with paragraph 98.
- (94) An entity applies the Statement of Financial Accounting Standards No. 14, *The Effects of Changes in Foreign Exchange Rates*, to financial assets that are foreign currency monetary items. Any foreign exchange gains and losses on monetary assets are recognized in profit or loss. An exception is a monetary asset that is designated as a hedging instrument in either a cash flow hedge or a hedge of a net investment (see paragraph 118–133). Changes in fair value of such assets shall be separated to those resulted from exchange gains or losses and those not resulted from exchange gains or losses which shall apply paragraph 108.

For the purpose of recognising foreign exchange gains and losses in profit or loss under the Statement of Financial Accounting Standards No. 14, *The Effects of Changes in Foreign Exchange Rates*, a monetary available-for-sale financial asset is treated as if it were carried at amortized cost in the foreign currency. Accordingly, for such a financial asset, exchange differences resulting from changes in amortized cost are recognized in profit or loss and other changes in carrying amount are recognized under paragraph 108(b).

For foreign currency financial assets that are not monetary items (for example, equity instruments), changes in fair value (including any related foreign exchange component) is recognized under paragraph 108. Foreign currency financial assets that are not monetary items and measured at cost shall be translated using the exchange rate at the date of the transaction.

If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognized in profit or loss.

#### **Held-to-maturity investments**

- (95) An entity does not have a positive intention to hold a financial asset to maturity if:
- (a) the entity intends to hold the financial asset for an undefined period;
  - (b) the entity stands ready to sell the financial asset in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms or changes in foreign currency risk; or
  - (c) the issuer has a right to settle the financial asset at an amount significantly below its amortized cost.

- (96) An entity shall not classify any financial assets as held to maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held-to-maturity investments). Any remaining held-to-maturity investments shall be reclassified as available for sale. On such reclassification, the difference between their carrying amount and fair value shall be accounted for in accordance with paragraph 108(b). The exceptions permitted are:
- (a) the sales or reclassifications are so close to maturity or the financial asset's call date (for example, less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;
  - (b) the sales or reclassifications occur after the entity has collected substantially all of the financial asset's original principal through scheduled payments or prepayments; or
  - (c) the sales or reclassifications are attributable to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.
- (97) An entity does not have a demonstrated ability to hold a financial asset to maturity if:
- (a) it does not have the financial resources available to continue to finance the investment until maturity; or
  - (b) it is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity. (However, an issuer's call option does not necessarily frustrate an entity's intention to hold a financial asset to maturity.)

#### **Subsequent measurement of financial liabilities**

- (98) After initial recognition, an entity shall measure all financial liabilities at amortized cost, except for:
- (a) Financial liabilities at fair value through profit or loss shall be measured at fair value.
  - (b) Derivative liabilities shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost.
  - (c) Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition in accordance with the Statement of Financial Accounting Standards No. 33, *Accounting for Transfers of Financial Assets and Extinguishments of Liabilities* shall be recognized for the consideration received. In subsequent periods, the entity shall recognize any income on the transferred asset and any expense incurred on the financial liability.
  - (d) Financial guarantee contracts as defined in paragraph 5 (unless those apply (a), (b) or (c)) and commitments to provide a loan at a below-market interest rate (unless those apply (a) or (b)) shall, after initial recognition, be measured by the issuer at the higher of:
    - (i) the contingent liability determined in accordance with the Statement of Financial Accounting Standards No. 9, *Contingencies and Subsequent Events*; and
    - (ii) the amount of deferred revenue initially recognized less, when appropriate, cumulative amortization in accordance with the Statement of Financial Accounting Standards No. 32, *Revenue*.

Financial liabilities that are designated as hedged items are subject to the hedge accounting requirements in paragraphs 118–133.

- (99) An entity applies the Statement of Financial Accounting Standards No. 14, *The Effects of Changes in Foreign Exchange Rates*, to financial liabilities that are foreign currency monetary items. Any foreign exchange gains and losses on monetary liabilities are recognized in profit or loss. An exception is a monetary liability that is designated as a hedging instrument in either a cash flow hedge or a hedge of a net investment (see paragraph 118–133). Changes in fair value of such liabilities shall be separated to those resulted from exchange gains or losses and those not resulted from exchange gains or losses which shall apply paragraph 108. Foreign currency financial liabilities that are not monetary items and measured at cost shall be translated using the exchange rate at the date of the transaction.

For foreign currency financial liabilities that are not monetary items, changes in fair value (including any related foreign exchange component) are recognized under paragraph 108.

If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognized in profit or loss.

#### **Fair value measurement considerations**

##### **Active market: quoted price**

- (100) If a published price quotation in an active market exists for a financial instrument in its entirety, the quoted prices is used to measure financial assets or financial liabilities. If it doesn't, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

##### **No active market: valuation technique**

- (101) If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation

techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

- (102) In applying valuation techniques, an entity uses estimates and assumptions that are available and consistent with the estimates and assumptions that market participants would use in setting a price for the financial instrument.

#### **No active market: equity instruments**

- (103) The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument is reliably measurable if:
- (a) the variability in the range of reasonable fair value estimates is not significant for that instrument, or
  - (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

#### **Reclassifications**

- (104) An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.
- (105) If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held-to-maturity, it shall be reclassified as available-for-sale and remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 108(b).

- (106) If a reliable measure becomes available for a financial asset or financial liability for which such a measure was previously not available, and the asset or liability is required to be measured at fair value if a reliable measure is available, the asset or liability shall be remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 108(b).

- (107) If, as a result of a change in intention or ability or in the rare circumstance that a reliable measure of fair value is no longer available or because the 'two preceding financial years' referred to in paragraph 96 have passed, it becomes appropriate to carry a financial asset or financial liability at cost or amortized cost rather than at fair value, the fair value of the financial asset or the financial liability on that date becomes its new cost or amortized cost, as applicable. Any previous gain or loss on that asset that has been recognized in equity in accordance with paragraph 108(b) shall be accounted for as follows:

- (a) In the case of a financial asset with a fixed maturity, the gain or loss recognized in equity shall be amortized to profit or loss over the remaining life of the held-to-maturity investment. Any difference between the new amortized cost and maturity amount shall also be amortized over the remaining life of the financial asset using the amortization method similar to the amortization of a premium and a discount. If the financial asset is subsequently impaired, any gain or loss that has been recognized in equity is reclassified from equity to profit or loss in accordance with paragraph 115.
- (b) In the case of a financial asset with no fixed maturity, the gain or loss recognized in equity shall remain in equity and, when the financial asset is sold or otherwise disposed of, shall be recognized in profit or loss. If the financial asset is subsequently impaired, any previous gain or loss that has been recognized in equity is reclassified from equity to profit or loss in accordance with paragraph 115.

**Gains and losses**

- (108) A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship shall be recognized, as follows.
- (a) A gain or loss on a financial asset or financial liability classified as at fair value through profit or loss shall be recognized in profit or loss.
  - (b) A gain or loss on an available-for-sale financial asset shall be recognized in equity, except for impairment losses and foreign exchange gains and losses of monetary financial assets, until the financial asset is derecognized. When the financial asset is derecognized, those cumulative gains or losses shall be recognized in profit or loss. However, interest from the amortization of the difference between the initially recognized amount and the maturity amount using the effective interest method is recognized in profit or loss. If the result to use the straight-line method approximates the result to use the effective interest method, the former can be applied.
- (109) For financial assets and financial liabilities carried at amortized cost, a gain or loss is recognized in profit or loss when the financial asset or financial liability is derecognized or impaired, and through the amortization process. However, for financial assets or financial liabilities that are hedged items, the accounting for the gain or loss shall follow paragraphs 121–133.
- (110) If an entity recognizes financial assets using settlement date accounting, any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognized for assets carried at cost or amortized cost (other than impairment losses). For assets carried at fair value, however, the change in fair value shall be recognized in profit or loss or in equity, as appropriate under paragraph 108.

**Impairment and uncollectibility of financial assets**

- (111) An entity shall assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 112 (for financial assets carried at amortized cost), paragraph 114 (for financial assets carried at cost) or paragraph 115 (for available-for-sale financial assets) to determine the amount of any impairment loss.

**Financial assets carried at amortized cost**

- (112) If there is objective evidence that an impairment loss on financial assets carried at amortized cost has been incurred, the amount of the loss is recognized and measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognized in profit or loss.
- (113) If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized (such as an improvement in the debtor's credit rating), the previously recognized impairment loss shall be reversed either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortized cost would have been had the impairment not been recognized at the date the impairment is reversed. The amount of the reversal shall be recognized in profit or loss.

**Financial assets carried at cost**

- (114) Investments in equity instruments and derivatives that are linked to and must be settled by delivery of such equity instruments shall be

measured at cost, if their fair value cannot be reliably measured. If there is objective evidence that an impairment loss has been incurred on such financial asset, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. Such impairment losses shall not be reversed.

#### **Available-for-sale financial assets**

- (115) When the impairment loss of an available-for-sale financial asset is recognized, the cumulative loss that had been recognized in equity shall be reclassified from equity to profit or loss. The amount of the impairment loss is measured as the difference between the acquisition cost (net of any principal repayment and amortization) and current fair value (for equity instruments) or recoverable amount (for debt instruments), less any impairment loss on that financial asset previously recognized in profit or loss. The recoverable amount of a debt instrument is the present value of expected future cash flows discounted at the current market rate of interest for a similar financial asset.
- (116) If, in a subsequent period, the amount of the impairment loss decreases, impairment losses recognized in profit or loss for an investment in an equity instrument classified as available for sale shall be reversed through equity, rather than through profit or loss. If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in profit or loss, the impairment loss shall be reversed through profit or loss.

#### **Interest income after impairment recognition**

- (117) If a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognized using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

#### **Hedging**

- (118) If there is a designated hedging relationship between a hedging instrument and a hedged item which is qualified for hedge accounting, accounting for the gain or loss on the hedging instrument and the hedged item shall follow paragraphs 121–133.

#### **Hedged items**

- (119) If the hedged item is a non-financial asset or non-financial liability, it shall be designated as a hedged item only for foreign currency risks, or in its entirety for all risks.

#### **Hedge accounting**

- (120) A hedging relationship qualifies for hedge accounting under paragraphs 121–133 if, and only if, all of the following conditions are met.
- (a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.
  - (b) The hedge is expected to be highly effective (see paragraph 78) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.
  - (c) For cash flow hedges, a forecast transaction that is the subject

of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

- (d) The effectiveness of the hedge can be reliably measured, ie the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.
- (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

#### **Fair value hedges**

(121) If a fair value hedge meets the conditions in paragraph 120 during the period, it shall be accounted for as follows:

- (a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with the Statement of Financial Accounting Standards No. 14, *The Effects of Changes in Foreign Exchange Rates* (for a non-derivative hedging instrument) shall be recognized in profit or loss; and
- (b) the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized in profit or loss. This applies if the hedged item is measured at cost or amortized cost. Recognition of the gain or loss attributable to the hedged risk in profit or loss applies if the hedged item is an available-for-sale financial asset.

(122) For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities (and only in such a hedge), the requirement in paragraph 121(b) may be met by presenting the gain or loss attributable to the hedged item either:

- (a) in a single separate line item next to financial assets, for those repricing time periods for which the hedged item is an asset; or
- (b) in a single separate line item next to financial liabilities, for those repricing time periods for which the hedged item is a liability.

The gain or loss attributable to the hedged item included in these line items shall be derecognized when the assets or liabilities to which they relate are derecognized.

(123) If only particular risks attributable to a hedged item are hedged, recognized changes in the fair value of the hedged item unrelated to the hedged risk are recognized in accordance with the original accounting principles.

(124) An entity shall discontinue prospectively the hedge accounting specified in paragraph 121 and no retroactive adjustment is necessary, if:

- (a) the hedging instrument expires or is sold, terminated or exercised;

For this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy.

- (b) the hedge no longer meets the conditions for hedge accounting in paragraph 120; or
- (c) the entity revokes the designation.

(125) Any adjustment arising from paragraph 121(b) to the carrying amount of a hedged interest-bearing financial instrument (or, in the case of a portfolio hedge of interest rate risk, to the separate line item in the balance sheet described in paragraph 122) shall be amortized

to profit or loss. Amortization may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be applied to hedge accounting. The adjustment is based on a recalculated effective interest rate at the date amortization begins. However, if, in the case of a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), amortizing using a recalculated effective interest rate is not practicable, the adjustment shall be amortized using a straight-line method.

The adjustment shall be amortized fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by expiry of the relevant repricing time period.

- (126) When an unrecognized firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognized as an asset or liability with a corresponding gain or loss recognized in profit or loss. The changes in the fair value of the hedging instrument are also recognized in profit or loss. When an entity enters into a firm commitment to acquire an asset or assume a liability, the initial carrying amount of the asset or liability is adjusted to include the cumulative change in the fair value of the firm commitment.

#### **Cash flow hedges**

- (127) If an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument, that excluded component of gain or loss is recognized in accordance with paragraph 108. Other included component of gain or loss shall be accounted for as follows, provided the hedge meets the conditions of cash flow hedge in paragraph 120 during the period:

- (a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognized in equity. The recognized amount is lesser of the following (in

absolute amounts):

- (i) the cumulative gain or loss on the hedging instrument from inception of the hedge (the ineffective portion described in (b) excluded); and
- (ii) the cumulative change in fair value of the expected future cash flows on the hedged item from inception of the hedge.

- (b) the ineffective portion of the gain or loss on the hedging instrument shall be recognized in profit or loss.

- (128) If a hedge of foreign currency risk of a forecast intragroup transaction qualifies for hedge accounting (see paragraph 67), any gain or loss that is recognized in equity in accordance with paragraph 127 shall be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated profit or loss.

- (129) If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognized in equity in accordance with paragraph 127 shall be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that interest income or interest expense is recognized). However, if an entity expects that all or a portion of a loss recognized in equity will not be recovered in one or more future periods, it shall reclassify into profit or loss the amount that is not expected to be recovered.

- (130) If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity shall adopt (a) or (b) below to the associated

gains or losses that were recognized in equity in accordance with paragraph 127:

- (a) It reclassifies the associated gains and losses that were recognized in equity to profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation expense or cost of sales is recognized). However, if an entity expects that all or a portion of a loss recognized in equity will not be recovered in one or more future periods, it shall reclassify from equity to profit or loss as a reclassification adjustment the amount that is not expected to be recovered.
- (b) It removes the associated gains and losses that were recognized in equity, and includes them in the initial cost or other carrying amount of the asset or liability.

An entity shall adopt either (a) or (b) as its accounting policy and shall apply it consistently to all hedges to which this paragraph relates.

(131) For cash flow hedges other than those covered by paragraphs 129 and 130, amounts that had been recognized in equity shall be reclassified to profit or loss in the same period or periods during which the hedged forecast transaction affects profit or loss (for example, when a forecast sale occurs).

(132) In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 127–131:

- (a) The hedging instrument expires or is sold, terminated or exercised. In this case, the cumulative gain or loss on the hedging instrument that has been recognized in equity from the period when the hedge was effective shall remain separately in equity until the forecast transaction occurs. When the transaction occurs, paragraph 129–131 applies.

The replacement or rollover of a hedging instrument into

another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy

- (b) The hedge no longer meets the conditions for hedge accounting in paragraph 120. In this case, the cumulative gain or loss on the hedging instrument that has been recognized in equity from the period when the hedge was effective shall remain separately in equity until the forecast transaction occurs. When the transaction occurs, paragraph 129–131 applies.
- (c) The forecast transaction is no longer expected to occur. In this case, any related cumulative gain or loss on the hedging instrument that has been recognized in equity from the period when the hedge was effective shall be reclassified from equity to profit or loss.
- (d) The entity revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that has been recognized in equity from the period when the hedge was effective shall remain separately in equity until the forecast transaction occurs or is no longer expected to occur. When the transaction occurs, paragraph 129–131 applies. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognized in equity shall be reclassified from equity to profit or loss.

#### **Hedges of a net investment in a foreign operation**

(133) Hedges of a net investment in a foreign operation shall be accounted as the following:

- (a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognized in equity; and
- (b) the ineffective portion shall be recognized in profit or loss.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognized in equity shall be reclassified from equity to profit or loss on the disposal of the foreign operation.

## V Disclosures

(134) Disclosures about financial instruments are required in this Statement and the Statement of Financial Accounting Standards No. 36, *Financial Instruments: Disclosure and Presentation*.

(135) An entity shall provide disclosure of the following significant accounting policies for financial assets or financial liabilities designated as at fair value through profit or loss:

- (a) the conditions for so designating such financial assets or financial liabilities as at fair value through profit or loss on initial recognition.
- (b) how the entity has satisfied the conditions in paragraph 12 and 86 for such designation. For instruments designated in accordance with paragraph 12(b)(i), that disclosure includes a narrative description of the circumstances underlying the measurement or recognition inconsistency that would otherwise arise. For instruments designated in accordance with paragraph 12(b)(ii), that disclosure includes a narrative description of how designation as at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.
- (c) the nature of the financial assets or financial liabilities the entity has designated as at fair value through profit or loss.

(136) An entity shall disclose separately the carrying amounts of:

- (a) financial assets that are classified as held for trading;
- (b) financial liabilities that are classified as held for trading;
- (c) financial assets that were, upon initial recognition, were designated by the entity as financial assets at fair value through profit or loss (ie those that are not financial assets classified as held for trading); and
- (d) financial liabilities that, upon initial recognition, were designated by the entity as financial liabilities at fair value through profit or loss (ie those that are not financial liabilities classified as held for trading).

(137) An entity shall disclose separately net gains or net losses on financial assets or financial liabilities designated by the entity as at fair value through profit or loss.

(138) If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it shall disclose:

- (a) the maximum exposure to credit risk at the balance sheet date of the loan or receivable (or group of loans or receivables),
- (b) the amount by which any related credit derivative or similar instrument mitigates that maximum exposure to credit risk,
- (c) the amount of change during the period and cumulatively in the fair value of the loan or receivable that is attributable to changes in credit risk, which may be determined by using one of the following methods. The used method shall be disclosed.
  - (i) the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or
  - (ii) using an alternative method that more faithfully represents the amount of change in its fair value that is

attributable to changes in credit risk.

If the entity finds that the disclosure does not faithfully represent the change in the fair value of the financial asset attributable to changes in credit risk, the reasons for reaching this conclusion and the factors the entity believes to be relevant shall be disclosed.

- (d) the amount of the change in the fair value of any related credit derivative or similar instrument that has occurred during the period and cumulatively since the loan or receivable was designated.
- (139) If the entity has designated a financial liability as at fair value through profit or loss, it shall disclose:
- (a) the amount of change during the period and cumulatively in the fair value of the financial liability that is attributable to changes in credit risk, which may be determined by using one of the following methods. The used method shall be disclosed.
- (i) the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or
- (ii) using an alternative method that more faithfully represents the amount of change in its fair value that is attributable to changes in credit risk.

If the entity finds that the disclosure does not faithfully represent the change in the fair value of the financial asset attributable to changes in credit risk, the reasons for reaching this conclusion and the factors the entity believes to be relevant shall be disclosed.

- (b) the difference between the carrying amount of the financial liability and the amount the entity would be contractually

required to pay at maturity to the holder of the obligation.

## VI Notes

- (140) This Statement was issued on December 25, 2003, with the first revision on September 22, 2005. The first revised provision of this Statement shall be effective for financial statements with fiscal years beginning on or after January 1, 2006. Earlier adoption is prohibited.
- (141) The transition to this Standard when this Standard is initially applied should be as follows:
- (a) for those transactions entered into before the beginning of the financial year in which this Standard is initially applied that the enterprise did previously designate as hedges, the provisions of this Standard should be applied prospectively. Therefore, if the previously designated hedge does not meet the conditions for an effective hedge set out in paragraph 120 and the hedging instrument is still held, hedge accounting will no longer be appropriate starting with the beginning of the financial year in which this Standard is initially applied. Accounting treatments in prior financial years should not be retrospectively changed to conform to the requirements of this Standard. Paragraphs 124 and 132 shall be applied to the hedging instrument to discontinue hedge accounting;
- (b) at the beginning of the financial year in which this Standard is initially applied, an entity should recognize all derivatives in its balance sheet as either assets or liabilities and should measure them at fair value (except for a derivative that is linked to and that must be settled by delivery of an unquoted equity instrument whose fair value cannot be measured reliably). Since all derivatives, other than those that are designated hedging instruments, are considered held for trading, the difference between previous carrying amount (which may have been zero) and fair value of derivatives

should be recognized as a cumulative effect resulting from the change to a new accounting principle at the beginning of the financial year in which this Standard is initially applied (except for a derivative that is a designated hedging instrument).

- (c) at the beginning of the financial year in which this Standard is initially applied, an entity should apply the criteria in this Standard to identify those financial assets and liabilities that should be measured at fair value and those that should be measured at amortized cost, and it should remeasure those assets and liabilities as appropriate. Any adjustment of the previous carrying amount should be recognized as;
- (i) a cumulative effect resulting from the change to a new accounting principle, if those financial assets and liabilities are financial assets and liabilities at fair value through profit or loss or derivatives which are subject to fair value hedges.
  - (ii) an adjustment to equity, if those financial assets and liabilities are measured at amortized costs or fair value as available-for-sale financial assets, or derivatives which are subject to cash flow hedges or hedges of a net investment in a foreign operation.
- (d) if an entity's hedge accounting policies prior to initial application of this Standard had included deferral, as assets and liabilities, of gains or losses on cash flow hedges, at the beginning of the financial year in which this Standard is initially applied, those deferred gains and losses should be reclassified as a separate component of equity to the extent that the transactions meet the conditions in paragraph 120.
- (e) transactions entered into before the beginning of the financial year in which this Standard is initially applied should not be retrospectively designated as hedges;

- (f) at the beginning of the financial year in which this Standard is initially applied, if non-monetary financial assets previously measured by using cost method (ie investments in foreign equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured) shall be measured at cost since this Standard is initially applied, those non-monetary financial assets should be remeasured using the exchange rate at the date of the transaction. Related cumulative translation adjustments recognized in equity shall be offset by allowance on translation adjustments or financial assets.

- (142) As soon as this Statement becomes effective, the Statement of Financial Accounting Standards No. 21, *Accounting for Convertible Bonds*, and No. 26, *Accounting for Bonds Issued with Stock Purchase Warrants* are no longer applied.

The provisions of this Statement need not be applied to immaterial items.